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GOVERNMENT CONTRACTING

A Proposal for a Program to Study the Profitability of Government Contractors





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**Comptroller General
of the United States**

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To the President of the Senate and the
Speaker of the House of Representatives

This report discusses our legislative proposal for establishing a program to study the profitability of government contractors. Management information, based on accurate and current data, and consistent and appropriate analysis is essential for efficient and effective federal program decisions. The federal government's policies regarding the profitability of government contractors can benefit from improved management information.

The most visible evidence that such improvements are needed is the current debate over whether profit policy objectives are being achieved. There is presently no legislatively mandated requirement to evaluate the extent that profit policy goals are being achieved and past executive branch profitability studies attempting to do this have been challenged because of their limited scope and differing analytical methodology.

The government should develop a systematic method of measuring the effect of its profit policies. This report explains why a structured and consistent profit reporting program is needed and offers draft legislation for the Congress to consider in establishing such a program.

Some have recommended that legislation mandating profitability studies be delayed pending resolution of issues of what are the best measures and criteria to use in studying contractor profitability. We believe that legislation need not be delayed while such details are debated. The issues which need to be addressed fundamentally deal with implementation and can be addressed by the Administrator of the Profit Reporting Program, with assistance from our office and others during the regulatory process. We are currently working with representatives of the Department of Defense and the Office of Federal Procurement Policy to develop methodology for future profit studies. However, should the Congress or others believe that modification of our proposed legislation is required before enactment, we will be happy to work with them to develop such modifications.

We are sending copies of this report to the Chairmen, Joint Economic Committee, Senate Committee on Governmental Affairs, and House Committees on Banking, Finance and Urban Affairs and Government Operations; the Director, Office of Management and Budget; the Secretary of Defense, and the Administrator of General Services.

Charles A. Bowsler
Comptroller General
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Overview

Historically, the Congress has expressed concern about profits received by government contractors. With government prime contract awards currently amounting to about \$200 billion a year and a significant amount of it being done with no or limited competition, the concern shows no sign of abating.

Profit Studies Demonstrate the Need for Consistent Recurring Profit Policy Evaluations

Over the past two decades, the Department of Defense (DOD) has made several ad hoc studies to assess how its profit policy is working to achieve profit levels that are equitable to industry and provide sufficient incentive to invest profits into capital facilities.

To date, these profit studies have played an important role in shaping DOD's profit policy. For example, DOD implemented the recommendations in its Profit '76 Study to induce contractors to invest in capital facilities. DOD's profit policy rule is based on its latest study, the Defense Financial and Investment Review (DFAIR). Results of the studies produced some controversy because they used inconsistent methodologies and voluntary contractor participation.

Framework for a Profit Reporting Program

GAO's report on DFAIR recommended more frequent and consistent profitability studies. With this report, GAO is providing the framework for a profit program that would require:

- a consistent and appropriate analytical methodology to evaluate profitability,
- a means for systematically establishing the integrity of the studies and the reliability of contractor-furnished data, and
- mandatory contractor participation.

Specifically, GAO is recommending legislation to require major government contractors to annually report financial results to an Administrator designated by the President, which it believes should be the Office of Federal Procurement Policy. The proposed legislation also defines the criteria for determining which companies will be subject to reporting requirements. The proposed legislation, which would create the Profit Reporting Program, is in appendix II.

Comments on the Profit Reporting Program

In November 1986, GAO issued an exposure draft for general comment, outlining its proposal for a program to study the profitability of government contractors.¹ Federal agencies, all contractors potentially affected by the proposed program, and others were asked to provide written comments on the draft. Comments were also requested from any person, company, association, or government agency with opinions on the proposal. Forty one responses were received. (Respondents are identified in app. I.)

GAO has considered all comments and has revised its original proposal to accommodate some of the views expressed. However, contractors and agencies remain opposed to the Profit Reporting Program. Their concerns and GAO's views are discussed below

Points raised by respondents were that:

- Continuation of DOD ad hoc studies of contractor profitability would be adequate to meet the needs of the government.

In GAO's view, it is difficult to sustain the position that DOD's studies have been adequate. The studies were not done in a consistent fashion with mandatory contractor participation. Further, the studies focused on the profitability of DOD contractors only. GAO believes the studies should include all major government contractors and the profit policies of all buying agencies that affect their profitability.

- The benefits to be derived may be outweighed by the costs to implement and operate the program.

GAO's proposal is designed to build upon and improve the methodologies DOD used to perform Profit '76 and DFAIR. The proposed program will also provide more frequent, and consistent data which should improve profit policy formulation. Because the proposed program requires less data than DFAIR, the cost of individual studies of the type GAO is proposing should not be unreasonable

- The federal government's ability to protect individual company proprietary information is questionable.

¹Government Contracting: A Proposal for a Program to Study the Profitability of Government Contractors (GAO/NSIAD-87-46 Nov. 1986)

Previous experience with the government having access to sensitive contractor data convinces GAO that data can be protected and the proposal includes limitation on access and penalties for disclosure. GAO believes that this, coupled with the requirements for protection of proprietary data, is adequate to protect the contractor's business data

- According to some respondents, implementation type questions should be answered before profit reporting legislation is presented to the Congress. To do this, one respondent suggested a multiagency team to brainstorm program details and process.

GAO's legislative proposal builds on prior DOD studies which have had the benefit of significant input by agencies and contractors. The basic approach is not new. The Profit Reporting Program Administrator can, with the assistance of any parties deemed essential, study and resolve the "how to" details during the regulatory process. Further discussion of the comments on the GAO proposal and GAO's evaluation of those comments can be found in appendix V.

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Abbreviations

CPA	Certified Public Accountant
DEAIR	Defense Financial and Investment Review
DOD	Department of Defense
GAO	General Accounting Office
K-L	Capital-to-Labor ratio
PRP	Profit Reporting Program
ROA	Return on Assets

Introduction

There is a long history of concern about profits earned on government contracts, particularly during wartime. Contract prices should allow contractors to recover their costs and provide a reasonable profit to compensate for investment, risk, and effort. However, concern with excessive profits has periodically prompted the Congress to legislate price ceilings, excess profit taxes, and renegotiation of contract prices.

Post performance renegotiation of contracts was for more than 25 years the prevailing method of profit control. The Renegotiation Act became inapplicable to contracts after September 30, 1976, and bills to reinstate various forms of renegotiation have been introduced but not passed in later Congresses. Today no statutory guidelines exist for comprehensively addressing government contractor profits on negotiated contracts. Rather, contractor profitability has been recently evaluated by infrequent and inconsistent studies of profit data voluntarily provided by contractors. These studies have been used to evaluate whether the Department of Defense (DOD) is successfully applying its structured profit policy. However, even though basically the same large companies are annually negotiating contracts valued at billions of dollars with federal civil agencies, similar studies have not addressed the profit policy goals of agencies such as the National Aeronautics and Space Administration, Department of Energy, and the Department of Transportation.

Our evaluation of the Defense Financial and Investment Review (DFAIR),¹ the latest DOD study, concluded that better information could be obtained if profit studies were regularly performed, based on data provided by specified contractors, and applying consistent analytical methodology. In that report, we recommended that the Congress consider legislation establishing a program for mandatory reporting of profitability on contracts negotiated with the federal government. This report provides a framework for a mandatory profit reporting program covering all government business.

¹Government Contracting: Assessment of the Study of Defense Contractor Profitability (GAO NSIAD-87-50 Dec. 23, 1986)

Profit Policy—A Means of Rewarding Contractors and Modernizing Industry

The federal government awarded prime contracts valued at about \$200 billion for fiscal year 1985. Of this amount, 82 percent, or almost \$164 billion were for defense. The preferred method of procurement for the federal government is full and open competition because the competitive forces of the marketplace are assumed to result in fair and reasonable prices. However, the majority of dollars the government spends, particularly for defense and space exploration, are for complex, nonstandard items which do not lend themselves to full and open competition, and must, therefore, be purchased without competition as the ultimate determinant of price. This means the government cannot rely on the marketplace to produce prices that are reasonable. To assess the reasonableness of a proposed contract price in a noncompetitive environment, the government buyer must analyze the validity of the contractor's proposed costs and reach agreement on the rate of profit. Government contracting officers employ a number of analytical techniques—such as cost and price analysis, audit, and weighted guidelines—to help them arrive at prices that they consider fair and reasonable.

It is in the government's interest to offer contractors opportunities for profit sufficient to (1) stimulate efficient contract performance, (2) not discourage companies from seeking government business, and (3) promote investment to enhance productivity, and provide for an adequate industrial base that will allow a quick buildup of defense items in case of emergency.

DDO implements its profit policy through the use of the weighted guidelines method—a technique for computing an overall profit. Generally, government negotiators are directed to use profit objectives when negotiating a contract. Under weighted guidelines, a profit objective is determined for several profit factors. The major factors used in determining the overall profit objective for a contract are (1) profit for performance risk, (2) profit for contract type risk, and (3) profit for investment. The sum of the profit objectives for these factors, plus cost of money, represents the overall profit objective for a contract. Federal regulations require that structured approaches be used by the Department of Energy, National Aeronautics and Space Administration, and other civilian agencies. To determine how effectively negotiation and contract performance have achieved profit policy goals, measurements of the results of these policies are necessary.

Although profitability studies have not been completed by civil agencies, studies have been performed by DOD and the services to determine the effect of profit policy. However, such studies are not required by

law or regulation, have not been performed at predetermined intervals, have been based on data volunteered by contractors, that has not been verified by the government, and have not been consistent in what elements of profitability they measure and how they measure them. As a result, the same type of data has been the basis for differing conclusions. The conclusions have caused changes in profit policy, some of which have resulted in DOD paying out more profits than intended; thus, other major profit policy changes, such as increasing the potential profit for investment and decreasing the profit objective for contractor's cost were considered. The effect of profit policy is not routinely evaluated based on consistent criteria, and the result of policy changes on industry is unknown until the next study is completed and its results analyzed and reported.

Objective, Scope, and Methodology

Our objective was to develop a means of routinely providing federal contracting officials and other government offices with aggregated and analyzed contractor financial and efficiency data to help them assess the effectiveness of government profit policy.

To carry out this objective we assembled a task force of evaluators and subject area experts. The task force drafted a framework for a Profit Reporting Program (PRP) and forms for reporting contractor financial and statistical data that we considered essential to implement the program. We presented a proposal for a profit reporting plan to a group of consultants. The consultants, comprised of individuals with years of high level organizational experience in both the government and private sector, recommended changes to our approach which were incorporated into our framework and forms.

We reviewed the history of congressional concern with contractor profits, emphasizing legislation passed to address the issue and committee reports highlighting specific concerns. We also reviewed prior studies of contractor profitability performed by DOD, the services, and our office.

We selected a comprehensive grouping of interested parties to consult on our proposal. The group included:

- 24 of the top defense contractors (in terms of dollar value of total prime contract awards in fiscal year 1985);
- 5 industry associations;
- 13 procurement, regulatory, and statistical agencies within the federal government;

- a Federally Funded Research and Development Center;
- the accounting firm that assisted DOD in its DFAIR study;
- a private consulting firm; and
- the American Institute of Certified Public Accountants (CPAs).

We discussed our framework and reporting form with 22 of the contractors, and all of the other agencies and businesses we contacted. The comments and opinions of the people we visited were presented to and discussed with the task force, and significant changes were made to both the proposed PRP framework and the reporting forms. Appendix I lists the offices we visited and our consultants.

Our review was performed in accordance with generally accepted government audit standards between February 1986 and July 1987.

A History of Government Concern With Contractor Profitability

Concerns over the level of profits government contractors earned are as old as the Nation. The Congress and the executive branch have responded to charges of contractors' unreasonable profits with a succession of laws, regulations, investigating committees, and studies. Except for the studies performed since the 1960s, past initiatives generally focused on limiting contractor profits by imposing profit ceilings or by recovering what were deemed excessive profits through taxes or renegotiation of contracts. These initiatives did not address the question of whether the government's profit policies were effective or needed adjustment.

Contractor Profits Have Been a Congressional Concern for Years

The history of efforts to deal with the issue of government contractor profits is important because it emphasizes the need for periodic studies of profitability based on a mandatory profit reporting system. Underpinning our economic system is the concept of a free market that establishes a fair price to the buyer and an equitable profit to the seller. However, because of aberrations in the marketplace, such as an escalating demand for war materials or the inability to obtain competition for many of the unique items which the government buys, the Congress, over the years, has found it necessary to address allegations of excess contractor profits. Congressional actions have included legislation which set prices, limit profits, and tax excessive profits or authorize the government to recover profits deemed excessive through renegotiation of contracts. These measures were generally taken without adequate information because it was not available.

Early Legislation Focused on Control of Profits Through Excess Profit Taxes and Price Fixing

Before World War I, the Congress made no sustained attempt to regulate the profits of arms manufacturers, perhaps because there was no permanent arms industry. Until the Navy authorized shipbuilding in the early 1880s, the Army and the Navy purchased very little in peacetime. Although legislation relating to bribery, corruption, and fraud in government contracting date to the Civil War, nothing was done to comprehensively regulate profiteering.

The Congress enacted legislation in 1897 to fix the price of armor plate for the Navy's ships. However, manufacturers refused to bid at that price, so when the Spanish-American War broke out in 1898, the law was first amended to increase the price and subsequently repealed in 1901.

During World War I the government attempted to control prices by instituting cost-type contracts and administrative price fixing of raw materials. Two successive excess profits tax laws passed in 1917 and 1918 were more successful. However, while yielding substantial revenues, only certain types of "excess" profits were covered and the taxes were too inflexible and too low to effectively limit profits, according to several congressional committees and other experts on the subject.

Between World Wars I and II, American industry was publicly criticized for taking in unreasonable profits during World War I. Some 200 bills and resolutions dealing with limits of wartime profits were introduced in the Congress. The Vinson-Trammell Act of 1934 limited profits on naval ship and aircraft contracts to 10 percent of the total contract price, and was later extended to Maritime Commission controls for merchant ships, and to Army aircraft contracts, with 12 percent profit allowed on aircraft.

Senator Gerald Nye's Committee was at work in the mid-1930s to investigate the munitions industry. The Committee noted that the War and Navy Departments had practically no information on the costs of war production or on profits, making it hard for contract negotiating officers to evaluate estimates from industry.

World War II—More Legislation

With the war's outbreak in Europe and the rising defense procurement in the United States, the Congress passed the Excess-Profits Tax Act of 1940, mainly as a revenue measure. The act suspended the profit limitations under Vinson-Trammell, which appeared to be impeding the placement of defense contracts.

The Supreme Court said in 1942 in United States vs. Bethlehem Steel Corporation:

" . . . if the Executive is in need of additional laws by which to protect the nation against war profiteering, the Constitution has given to Congress . . . the power to make them."

It was wartime, and the only legislation addressing excess profits was through the tax laws. The Congress later passed the Renegotiation Act of 1942 enabling the government to renegotiate the price on certain defense contracts on which excessive profits were realized. Unlike the suspended profit ceiling imposed by Vinson-Trammell which covered

only ship and military aircraft contractors, this law extended profit limits to war contracts generally. It led to the recapture of a reported \$11 billion in excess profits, and expired when the war ended in 1945. With the expiration and the repeal of the excess profits tax, the Vinson-Trammell Act was reactivated and left as the only statutory control over profits.

The Congress passed the Renegotiation Act of 1948 to reinstitute renegotiation on a limited basis. Vinson-Trammell was not applicable to contracts subject to the 1948 act. For many years renegotiation was the prevailing method for recovering excessive profits. Coinciding with the involvement in Korea, the Renegotiation Act of 1951 created a Renegotiation Board and extended the review of government defense contracts, seen as too profitable, to contracts for the government civil departments and agencies and broadened the category of contracts not subject to Vinson-Trammell, but did not repeal it. The controversial Renegotiation Act was reauthorized repeatedly before becoming inapplicable to contracts after September 30, 1976. The Renegotiation Board did not receive an appropriation in 1979 and ceased operation.

When the Renegotiation Board ceased operations, the Vinson-Trammell Act once again became effective. The Congress abolished the peacetime application of Vinson-Trammell in 1981 and provided that in wartime, the President would have the discretion to set limits on contractor profits.

The Congress Needs More Accurate and Consistent Cost Data

During the 1960s, the Congress took a hard look at contractor costs, particularly costs for large defense contracts, and passed two laws intended to ensure better information on contractor costs.

Because of concern over some contractors inflating their cost estimates and obtaining excessive profits, the Congress passed the Truth in Negotiations Act of 1962. This act requires contractors to certify that their cost or pricing data used in negotiating contracts are current, accurate, and complete, and authorizes the government to recover any overcharge attributable to defective data. Although the act's effectiveness has been questioned and its implementing regulations in DOD have been criticized, Truth in Negotiations is clearly a useful tool for obtaining good data for negotiations which in turn is used as a basis for determining individual contract profit objectives.

During the late 1960s, cost measurements applied to government procurements by contractors were being severely criticized. The criticisms centered on the contractors' ability to use any generally accepted method of determining costs. To build more uniformity and consistency into cost accounting practices for government contracts, Public Law 91-379 was enacted in August 1970 creating the Cost Accounting Standards Board. During its 10-year existence, the Board issued 19 separate cost accounting standards that have made it possible to achieve increased uniformity and consistency in cost accounting.

DOD procurement outlays for the Vietnam War peaked in 1968, the year the Congress' Joint Economic Committee and its Subcommittee on Economy in Government began investigating defense procurement and publicizing cost overruns. The Subcommittee's 1969 report criticized the absence of comprehensive profit reports and studies and the lack of uniform accounting standards. The report also asserted that "Perhaps the most glaring fact about defense profits is that not enough is known about them."

In 1969, the pressures on the Congress to limit military spending and the growing exasperation with what some members saw as DOD's failure to report accurate data on its costs, led the Congress to address these issues in the Armed Forces Appropriation Authorization Act for fiscal year 1970. We were directed by the act to make a study of the profits made by defense contractors and subcontractors. The study was made on a onetime basis and our report¹ was issued in 1971.

Our study which measured profit as a return on stockholder's equity, found little difference between profits on defense work and on commercial work for large defense contractors.

The study, also citing previous analyses performed by the Logistics Management Institute, noted the concern expressed in congressional hearings that contractor capital requirements had not been considered in negotiating contract prices. Instead, profit objectives were being developed as a percentage of expected costs, which after a period of time would penalize investments in cost reducing equipment. We recommended that governmentwide guidelines be developed for determining

¹Defense Industry Profit Study (P-159896 Mar. 17, 1971)

profit objectives that emphasized consideration of the capital investment required to perform a contract. The facility capital investment factor was first included in weighted guidelines as a result of the DOD Profit '76 Study.

Present Situation

Today, there are no statutory standards to directly regulate government contractor profits, except to a limited extent on an individual contract basis.² The discontinued operation of the Renegotiation Board and the peacetime repeal of Vinson-Trammell, have further reduced the opportunities for the government to control defense contractor profits. The determination of profit policy, therefore, is primarily left to the agencies to address administratively and efforts to fund the operations of the Renegotiation Board by some members of Congress have not been successful.

Some of the initiatives for determining and regulating government contractor profits that evolved over the years were clearly necessary and have been useful. The law establishing cost accounting standards and the Truth in Negotiations statute were major initiatives. However, except for profit studies made since the 1960s, none of the previous initiatives, either individually or collectively, addressed the question of whether the government's profit policies were working as intended.

Profit Studies

Broad studies of profitability on government contracts can be used to determine if profits on government business are in line with the goals of government profit policies. Studies can also be used to find out whether profitability on government contracts is comparable with commercial contractors for similar goods and services. The aggregate profitability of contractors supplying goods and services primarily to civil agencies of the federal government has not, as far as we can determine, been studied. However, the profitability of defense contractors has been the subject of several studies. Such studies have provided valuable data and information on this complex and sensitive issue. However, the studies have been based on data not verified by the government, volunteered by contractors willing to participate in the study, and that has been analyzed using various methodologies. As a result, study conclusions have

² Cost-plus-fixed-fee contracts are limited to a 15 percent fee on estimated costs for experimental, development, or research work, and 10 percent for other types of work. Cost-plus-incentive-fee and cost-plus-award-fee contracts are similarly limited but the limits may be waived. Fees for architect-engineering services are limited to 6 percent of the estimated cost.

been inconsistent and the results have been criticized because of the inconsistent or inappropriate methodologies that have been used.

During the 1960s DOD contracted with the Logistics Management Institute to study the profitability of defense contractors. Also following our congressionally mandated study in 1971, four separate studies were made, two by DOD—Profit '76 and DFAIR, one by the Air Force Systems Command, and one by a consultant for the Navy. All the studies compared the profitability of government work to commercial work and some resulted in changes to DOD's profit policy

Inconsistent Study Methodology Produces Different Profitability Conclusions

Profitability measures derived from aggregated financial data supplied by government contractors have produced different conclusions, depending on how the measures were calculated and what time period was analyzed. For example, DFAIR concluded that between 1970 and 1979 the return on assets (ROA) for defense contractors on defense work was approximately the same as the ROA earned by durable goods manufacturers; from 1980 to 1983, defense contractors' ROAs were higher. If DFAIR had subtracted government progress payments from the asset base to compute the ROA, as DOD did for Profit '76, it would have concluded that between 1970 and 1979 defense contracting was 35 percent more profitable than commercial manufacturing, when defense contractors and commercial manufacturers earned ROA of 19.4 percent and 14.4 percent, respectively. From 1980 to 1983 the profitability gap increased as defense contracting became about 120 percent more profitable, earning 23.3 percent ROA versus 10.6 percent for commercial manufacturers.

Data from the defense studies covers a 15-year time frame which is enough time to identify profitability trends. However, because criteria and methodology for the studies have been inconsistent, and because the most recent studies have not built upon earlier studies, trends cannot be determined. A review of the four recent defense studies highlights the differences.

- Each study covered a different sample of government contractors with no standard criteria for their selection.
- Each study used a different method to analyze contractor profitability.
- The two most comprehensive studies, Profit '76 and DFAIR, were based on data not verified by the government and volunteered by contractors. A significant number of contractors refused to participate in either study and several provided data that were not usable.

- Each study was performed on an ad hoc basis and the length of time between studies varied.
- For the Navy study, annual financial reports were used to determine profitability. Although these reports are intended to inform the investing public, they are not adequate for profitability studies because government business segments are not consistently defined.

All these differences have contributed to a problem in establishing a reliable data base from which to observe profitability trends and make profitability comparisons. A high degree of consistency is needed if profit studies are to be used to consider whether profit objectives have been met and whether profit policies should be revised.

Although the four defense studies conceptually used many of the same analytical ratios to compute profitability, the components of the ratios were not always the same for each study. Appendix VI highlights the different profitability measures used and the conclusions reached on the relative profitability of government versus commercial work.

Profit Studies and Profit Policy Changes

As a result of Profit '76, DOD added a new incentive to its profit policy—making cost of money an allowable cost and adding a percentage of the total profit objective for contractor investment in facilities capital. To ensure that the addition and the concurrent introduction of Cost Accounting Standard 414 would not result in increased profit levels, DOD reduced the objective allowed for cost related policy elements. DOD increased the share of the total profit objective for facilities capital in 1980. However, it did not make further offsets to profit objectives based on cost. The result could cause an unintended increase in total profits of \$1.4 billion in 1 year. This problem was not confirmed until DPAIR was completed. DOD is planning to introduce major changes to its profit policy in 1987, which should significantly increase the total profit objective for investment and greatly reduce the amount of profit based on cost. The new policy is also intended to reduce overall profit levels. Because DOD does not have a program to routinely evaluate the effect of profit policy changes, the results of these changes will probably not be known until the next ad hoc study is completed or a study is performed under our proposed program.

Conclusions

Profits earned on government contracts have been and probably always will be a subject of interest to the Congress, the President, and the American people. History suggests that such interest has increased as

Chapter 2
A History of Government Concern With
Contractor Profitability

DOD expenditures have grown. This interest centers on the defense industry because it consumes such a large share of the total federal procurement dollars; however, profitability of civil agency contractors is also important. Profit ceilings have been removed from the Vinson-Trammell Act, and the Renegotiation Act became inapplicable to contracts after September 30, 1976, reducing government awareness of contractor profitability. Although recent profitability studies have provided some information on the effectiveness of DOD's profit policy, performing such studies on a recurring basis is not required. If various government agencies study profitability at varying times using diverse methods, the results of the studies will be subject to varying interpretations and misunderstandings. The studies should be based on a consistent criteria, and the data provided for the studies should be verified. We believe it is feasible and desirable to statutorily require periodic profitability studies that

- provide reliable data to monitor contractor profits and investment;
- provide a basis for reliable comparative studies, both historical and inter-industry; and
- establish a reliable basis for modifying profit policies as required.

A PRP for Government Contractors

The proposed PRP will allow the government to gather data and study contractor profitability on a regular and consistent basis for the first time. PRP would require the minimum amount of data and analysis needed to study profitability pertinent to government business. In configuring PRP, the requirements of previous profit studies and the capability of the companies to provide the data and the costs of providing such data were considered.

Under PRP, the government contractors which meet the criteria will be required to submit annual financial and statistical data to a central government office for the purpose of

- studying levels of profitability and efficiency of the companies and comparing their profitability to companies in the private sector which provide similar goods and services;
- reporting the results of the studies to the President of the United States, the Congress, and heads of executive agencies;
- providing indications when changes to the profit policy may be needed; and
- recommending to procuring activities within executive agencies, changes needed in profit policies to achieve stated objectives

In addition, PRP will serve to increase public trust and confidence in the government's procurement system.

The costs of PRP are unknown at this time for several reasons as discussed on page 29. It is anticipated that most of the data required will be available from many companies existing financial reporting systems. We believe added costs would be a onetime set-up cost. Also, data requirements, which many company representatives said affect costs, are substantially less for PRP compared with DPAIR and other profit studies. We believe that in the long run PRP costs will be reasonable compared to the benefits—ensuring implementation of profit policies that are designed to provide adequate profits to contractors and to minimize the costs of the goods and services procured by the government.

Framework of PRP

The PRP structure is contained in the draft PRP bill. (See app. II.) It would require the President to appoint an Administrator to implement the program. Our proposal defines the principal responsibilities of the Administrator, contains criteria for determining which companies will be subject to PRP, and sets forth other essential requirements of the program.

Our proposal would require the Administrator to establish a uniform system for collecting company data, analyzing it, and reporting on the results of the analyses. Companies receiving awards or payments from the federal government on negotiated contracts for which certified cost and pricing data was required and which totaled \$50 million or more in 2 consecutive years will submit financial data at the segment¹ level to the Administrator.

The Administrator will do a study at least once every 3 years on the profitability and investment of companies using various ratios. The Administrator will issue a report to the President, the Congress, and the Comptroller General by December 31 of each year. The reports will contain the results of studies from the preceding year, recommendations to revise or develop profit policy when necessary, and actions taken in response to previous recommendations. The Administrator is required to keep all company data confidential, that is, no company specific data is authorized to be disclosed.

Our proposal contains several provisions to ensure the reliability of the company data and profitability studies. One provision would require the companies' independent CPA to submit a report to the Administrator. The Administrator is authorized to review the companies' supporting records and CPA working papers. The Comptroller General would be authorized to review and evaluate the profitability studies and all supporting records and documents as needed.

The Administrator would be permitted to arrange with another government activity or to contract for assistance in carrying out PRP functions.

Our proposal does not define all the data needed to do the studies. Rather, it authorizes the Administrator to prescribe the precise information required for the analysis.

Administration and Regulation of PRP

The President will initiate PRP by designating an Administrator to implement PRP. The Administrator will be responsible for issuing rules and regulations to administer and regulate the program. Among these, the Administrator will need to establish safeguards to protect the confidentiality of company data as provided in the draft bill. The Administrator

¹Segments are defined as a division, product department, plant, or other subdivisions of a company usually identified with responsibility for profits or producing a product or service. A company that is not subdivided into segments will be considered as a segment. Segments for the purpose of PRP are based on the criteria developed by the Cost Accounting Standards Board.

can, when deemed appropriate, revise the company dollar reporting threshold, exclude certain classes of companies, and exempt company segments from reporting.

Who Should Administer PRP?

The PRP functions could be performed by each executive agency that buys goods or services or performed by one of several other government activities. However, from the standpoint of uniformity and consistency of the studies centralized administration of PRP should be more efficient and effective. Having one organization responsible for the studies provides the additional advantage of a single point of contact for the companies to deal with and should minimize the opportunities for unauthorized disclosure of company data.

Consideration should be given to delegating PRP responsibilities to the Office of Federal Procurement Policy within the Office of Management and Budget. The Office of Federal Procurement Policy is responsible for formulating procurement policy for all federal agencies and can demonstrate an independent attitude in evaluating profit policy because it does not award contracts for goods or services.

We discussed implementation of PRP with representatives of some government activities that collect, process, and publish statistical data obtained from the private sector. These included the Federal Trade Commission, Bureau of the Census, Bureau of Labor Statistics, and the Bureau of Economic Analysis. Representatives of these agencies stated they would not want to be responsible for implementing PRP because it would not be compatible with their mission. We have no opinion as to whether PRP would adversely affect the agencies' missions. However, if it is found that missions are not affected, we believe it may be feasible for one of these activities to assist the Administrator in collecting or processing data reported by the companies.

Ensuring Confidentiality of Company Data Is Important

Disclosure of company specific data could seriously affect the competitive or other advantages that a company may enjoy. Confidentiality or protection of data is a major concern. Under PRP, access to company data will be limited to the Administrator (or agent of the Administrator) and the Comptroller General. PRP prohibits any officer, employee, or contractor of the Administrator or our office from disclosing any company specific data to any individual or establishment not specifically authorized by the PRP Act. (See app. II.) This prohibition is intended to include all

branches of the federal government. Penalties of fines or imprisonment or both are imposed for unauthorized disclosure of data.

The Administrator will be responsible for ensuring that adequate safeguards are established and maintained over the data received and files created from the data

Strong measures are needed to ensure industry its data will be protected. Confidentiality provisions in the earlier DOD studies prohibited disclosure of specific company data. For specific government agencies authorized in the bill, PRP expands access to both government and commercial data for reportable segments doing government business. The bill provides enhanced protection to industry against disclosure of their sensitive financial information.

Administrator May Regulate the Number and Type of Companies and Segments That Will Be Required to Report Data

Under our proposal, companies would be subject to PRP if they were awarded or received payments of \$50 million on qualifying government contracts for 2 consecutive years. Qualifying contracts are those negotiated fixed price and cost reimbursable contracts for which certified cost and pricing data were required. Companies would continue to be subject to PRP until payments on qualifying government contracts dropped below the threshold for 2 consecutive years.

For purposes of determining whether companies meet the coverage criteria, the value of subcontracts awarded on the basis of certified cost or pricing data are not to be included. However, companies which otherwise meet the coverage criteria must submit for the PRP financial data on the subcontracts they receive. The value of qualifying contracts representing foreign military sales is to be considered when determining whether companies meet the coverage criteria if the items are purchased by the U.S. government and are intended for resale to a foreign government. Other contracts negotiated directly by foreign governments are not to be considered when determining whether companies meet the coverage criteria, but companies must submit financial data on these contracts if they otherwise meet the coverage criteria. (See app. IV.)

Two very important items to be considered when selecting a reporting sample are: (1) ensuring that, in terms of total dollar value, a significant amount of the government's prime contract awards are included and (2) including the companies that are annually negotiating the largest contracts or receiving the largest payments on prior year negotiated contracts. To ensure adequate coverage, the PRP studies should be based

on at least 60 percent of the dollar value of the annual prime awards from defense and civil agencies. However, the administrator should decide on the specific number of companies required to report segment data.

An analysis of fiscal year 1985 procurement data showed that 133 companies, including over 905 segments, received \$50 million or more of qualifying government contracts from defense and civil agencies. These companies accounted for about 63 percent of the total prime contracts awarded. A reporting threshold of \$50 million includes approximately the same number of companies requested to provide data for prior DOD studies. The Administrator is authorized to revise the \$50 million threshold if deemed appropriate, which will result either in an increase or decrease in the number of covered companies. The Administrator's only restriction is that the number of companies reporting must account for at least 60 percent of the total dollar value of the prime contracts awarded.

The Administrator also has the authority to exclude certain companies based on types of organizations or types of products or services provided. For example, these could be foreign companies, nonprofit companies, or manufacturers of products whose prices are set by law, regulation, or whose prices are based on competitive market conditions.

Further, not all company segments need to report. Company segments that do only commercial work are not required to report. Companies can also request a waiver from the Administrator to exclude a segment or segments if the volume of government business for the segment is less than 10 percent of the companies' total government business.

The Administrator is authorized to exempt companies or grant waivers to company segments only after determining that the exclusion will not impair the results of the profitability studies. The Administrator should also disclose in the annual reports, the companies or classes of companies exempted and segment waivers granted and the reasons for the exclusions.

Profitability Analyses, Reporting, and Data Requirements

Companies subject to PRP are required to submit selected income statement and balance sheet data to the Administrator annually. The Administrator will analyze the companies' profitability and certain elements of efficiency, by performing studies and issuing profitability reports at least once every 3 years.

To ensure the reliability of the PRP data, the companies are required to reconcile PRP data to their published financial statements, and have their independent CPA firms provide assurance that the data is reliable. The Administrator is authorized to review and verify the companies' records and examine the CPA's working papers.

Profitability Studies

The PRP studies are intended to provide overall indicators and information on how well the government's profit policies are working. Based on the financial data submitted by the companies/segments, profitability under PRP will be studied by computing ROAS and other ratios as the Administrator deems appropriate. For example, other analyses can include the return on sales and capital-to-labor ratios. (A discussion of the ratios and their use in measuring profitability and efficiency is contained in appendix IV.) While we believe that analyses based on ROAS should be the principal measure used to analyze profitability, we recognize that ROA may not be the most appropriate or may be somewhat misleading when profitability comparisons of certain classes of contractors such as service companies are made. Because the asset base of service companies is much lower than manufacturing companies, the use of return on sales may be more appropriate to analyze profitability of these companies.

Profitability studies will be performed at least once every 3 years. It is also intended that each successive study will add to the previous study, that is, the current study will include the data used during the earlier study or studies. Studies based on cumulative data will help reduce the effect of short-term fluctuations in profits and other economic conditions that affect profits. Such studies should provide a reliable basis for measuring segment profitability, making the profitability comparisons described below, and evaluating the effects of profit policies.

Profitability data (ratios) will be aggregated for similar products and comparisons of the companies' profitability of industry groups made

- under government negotiated cost and fixed-price contracts for which certified cost or pricing data was supplied and with all of its other business and
- with profitability of companies in the private sector providing similar goods and services.

The data will also provide a basis to study how well the government's profit policies are working by assessing over time

- whether variations between levels of profitability are reasonable (see part IV, app. IV);
- how structured pricing policies (for example, use of weighted guidelines) motivate company efficiency and the relative efficiency between the companies' government and other business (see part IV, app. IV);
- the relationship of payment policy (for example, progress payments) and contract pricing (see part IV, app. IV); and
- the companies' capital investment and the relative investment between the companies' government and other business (see part V, app. IV).

In addition to the regular profitability studies, the Administrator is authorized to make special studies as appropriate. These may include studies by certain classes of products, companies, federal agencies, or on the effectiveness of government financing techniques.

Administrator's Annual Reporting Requirement

The Administrator is required to annually submit reports identifying the profitability studies and any other interim studies that may be made to the President, the Congress, and to the Comptroller General. As a minimum, the reports should include (1) actions taken under the Administrator's authority to grant waivers or exclusions and (2) recommendations for the executive agencies or the Congress to consider relative to profit policies. The Administrator is not authorized to change profit policies.

The reports are to be issued no later than December 31 of each year. Annual reporting is suggested because, even if a study was not done during the preceding year, the Administrator may have taken actions or made recommendations which would be of interest to the Congress. No specific format for the reports is defined under PRP, but the Administrator is required to assure that the reports will contain only aggregated data and not disclose sensitive individual contractor data.

Company Financial Data Reporting Requirements

Our proposal requires companies to report financial data for each segment in a manner that distinguishes between its government business and all other business. The data submitted will include a reconciliation with the financial statements filed with the Securities and Exchange Commission or their audited financial statement. This requirement will ensure that the data submitted to the Administrator is based on the companies' financial systems and is consistent with the companies' annual financial statements and that any differences are adequately explained.

Companies will report segment data separately for cost reimbursable and fixed-price contracts and subcontracts, where certified cost or pricing data is required and all other company business. For PRP, other business includes commercial business and government sales which are not based on cost or pricing data, such as catalog or established market price items and sales under sealed bids and contracts awarded based on price competition.

Income statement and balance sheet data should be broken out for each contract type and for the segments' other business and include such items as sales, cost of sales, net operating results for the income statement, applicable current and fixed assets, including accounts receivable for the balance sheet. Some information will be requested on a segment-wide basis, such as depreciation expense, labor cost, cost of money, and number of employees.

To enable the Administrator to make studies and comparisons of profitability by product classes or federal agencies, companies will be asked to report the two major products sold to the government using the Office of Management and Budget 4-digit Standard Industrial Classification codes² and also to identify the main federal agencies for whom the products were made.

A proposed format for reporting the financial data is contained in appendix III.

Segments Are the Most Appropriate Level for Reporting Company Financial Data

Many companies have numerous divisions and subdivisions of which all or only some may perform reportable work for the government. We believe segments like those used by the Cost Accounting Standards Board are the most feasible and appropriate level for reporting company financial data because they are discrete reporting units which are frequently aligned with the companies' divisions, subdivisions, or products. We also believe that reporting by segments will provide a uniform and consistent data base for studying profitability since segments are required (1) to be used by companies doing business with DOD and some

²The Standard Industrial Classification codes are used to classify establishments or kind-of-activity units on the basis of their primary activity which is determined by the product or group of products produced or handled or service rendered. The major activity of an establishment is assigned a 2-digit code. A 3-digit code is assigned to the industry groups within the major activity. The 4-digit code identifies specific products, services within the industry groups. For example, Chemicals and Allied Products is a major activity (assigned a 2-digit code), Industrial inorganic chemicals, drugs, soaps, etc., are industry groups (assigned a 3-digit code) within the major activity. Industrial gases is a 4-digit product group of the industrial inorganic chemicals industry group.

civil agencies and (2) segments are required to follow a set of uniform cost accounting practices. Some companies are not now required to establish segments. Those companies would apply the Cost Accounting Standards Board type segment criteria for reporting purposes only.

The feasibility of using Cost Accounting Standards Board segments for reporting was demonstrated in the DPAIR study. That study successfully obtained financial data at the Cost Accounting Standards Board segment level. Further, representatives of most of the companies that we interviewed confirmed that they could report financial data by the Cost Accounting Standards Board segment. Some stated that Cost Accounting Standards Board segments were the most appropriate form for submitting the data.

Reliability of Company Data

Because profit policy decisions will be based largely on the results of the profitability studies, it is essential that company data be reliable. To establish and ensure the reliability of company data, PRP requires the company's CPA firm to report on the reliability of the data and authorizes the Administrator to review and verify company data and to review CPA firm working papers when necessary.

Under PRP, a company's CPA firm will be required to submit reports on the reliability of the company data to the Administrator. To accomplish this, we are recommending that CPA firms apply agreed-upon procedures in accordance with the American Institute of CPA's Statement on Auditing Standards Number 35¹ which covers financial statement data and in accordance with the American Institute of CPA's Statement on Standards for Attestation Engagements for data not covered by Statement on Auditing Standards Number 35.

The use of agreed-upon procedures is appropriate for PRP because, as indicated in both of the above statements, the scope of work to be performed by the company's CPA firm is less than required by an audit performed in accordance with generally accepted auditing standards, and most of the data to be submitted by the companies would come from their audited financial statements. The use of agreed-upon procedures, therefore, allows the Administrator to define the level of assurance

¹Special Reports - Applying Agreed-Upon Procedures to Specialized Elements, Accounts, or Items of a Financial Statement

required and limit the company's CPA firm's efforts to the extent necessary to satisfy the Administrator's needs and thereby minimize CPA engagement fees.

It is necessary for the Administrator to have access to company records to ensure that the requirements for submitting data are interpreted and reported on a consistent basis. This access is needed to ensure the integrity of the data and to determine what changes are needed to improve the system.

Making the PRP Work

Since disclosure of company data is prohibited and profitability reports will contain only aggregated data, several provisions have been included in PRP to ensure the integrity of the program. The provisions are for the purpose of requiring companies to have their independent CPA report on the data submitted and for the Administrator to review supporting company and independent CPA working papers.

However, to further ensure the Congress and the public that the PRP studies are providing reliable information on the relationships of government contractors' profitability and profit policies, PRP legislation authorizes the Comptroller General, when deemed appropriate, to make independent reviews of the profitability studies and supporting records and working papers of the independent CPA's and contractors. The Comptroller General will assess the adequacy of the profitability studies and may do limited testing of supporting company and independent CPA working papers.

Cost of PRP Cannot Be Determined Now

Data was not available which would enable us to estimate the costs of a PRP. The PRP data and analytical requirements and number of covered contractors are comparable with the DFAIR requirements and consequently the cost should not be significantly different. We believe that the Administrator can implement and manage the PRP with a small staff and with the assistance of a contractor or other government agency to process the data. Further, we believe that the costs of the PRP would be reasonable relative to other alternatives such as if the Contract Renegotiation Board were reinstated.

The benefits of the PRP are difficult to quantify. The value of PRP lies in the timeliness and integrity of the information provided. We believe that PRP will provide reliable and consistent profitability analyses to government decisionmakers on a regular basis and improve their ability to

adjust profit policies in order to assure that fair and reasonable profits are paid to contractors.

Company representatives said that implementing PRP would be costly. We believe costs cannot be reliably estimated until the specific requirements of the PRP and its effect on company accounting and reporting systems are evaluated. According to company officials, costs will be directly related to

- the number of company segments subject to reporting;
- the extent of the data requirements and allocations of costs to the breakouts required, that is, by type of contract, commercial business, and so forth, and availability of the data from the companies' accounting and financial reporting systems; and
- independent CPA engagement fees.

Neither DOD nor the contractors we visited have records detailing the costs of previous studies, therefore, we were unable to make cost estimates for PRP based on prior study experience. A prior Logistics Management Institute President testified before the House Committee on Government Operations in March 1987, that the profitability studies the Logistics Management Institute performed for DOD were made by a staff of three full-time professionals and with limited use of outside subcontractor support.

PRP, as structured, requires less company data than earlier studies obtained, and after initial system set-up costs, annual data submission for PRP, especially if done in conjunction with certification of annual financial statements, may be more efficient than reconstructing data from several prior year segment records, as was the case for previous studies. DFAIR and Profit '76 collected 9 to 10 years of data. This effort required considerable time and cost for the contractors to gather the data, as well as for reviewing, reporting, and processing the data. The DFAIR study observed that the availability and quality of data would be improved and obtained with less effort with more frequent studies and recommended 3 to 5 years between studies.

We are proposing that company data be submitted annually. Annual data will allow the Administrator to perform profitability studies on a more frequent basis if the Administrator believes it is appropriate, and to also make special interim studies. Many company representatives said that the greatest costs would be incurred in setting up the PRP system, but some added that recurring costs should be less. Thus, we believe

that the additional cost of requiring annual company reporting should not be significantly higher than less frequent reports for ad hoc studies.

The direct costs incurred by the government will depend on staff, space, and equipment needed to collect, process, analyze, and issue profitability reports. These can vary depending on whether the PRP functions are performed internally by the Administrator or whether other federal agencies that collect and analyze data received from companies (Bureau of Economic Analysis, Bureau of Census, or others) can perform or assist the Administrator in performing these functions, or whether part or all of the data collection and analyses are contracted out.

In summary, PRP parallels but attempts to improve on the profit studies made in recent years. Under the proposed system contractors would report less financial data and avoid the costs associated with reconstructing older periods of financial data. Some major contractors who were not asked to or declined to voluntarily report would be required to report under PRP. Study requirements and data aggregation costs would be similar to previous studies, but studies for PRP would be done more frequently. These enhancements will improve the quality of the studies and the supporting data.

Issues for the Administrator to Consider Before Implementing PRP

The PRP defines the Administrator's overall role, authority, and responsibilities with respect to initiation and execution of PRP and sets forth other essential requirements needed to do profitability studies. It was not intended to define all of the rules, regulations, or procedures necessary to implement or carry out the program. For example, our proposal does not specify the financial data to be submitted by the contractors or specific criteria for measuring profitability. The financial data requirements contained in appendix III and the analyses outlined in appendix IV of this report are what we believe are necessary to do profitability studies.

The Administrator is required to establish the data requirements and other procedures to satisfy the requirements of the PRP. This flexibility will enable the Administrator to obtain additional input from all parties concerned before issuing the rules and regulations. It will also enable the Administrator, should changing conditions require, to revise the rules and regulations in order to meet future information requirements of government policymakers and the Congress.

In addition, respondents who submitted comments on the exposure draft of the report identified several issues and made many suggestions to improve PRP. We believe that their ideas should be considered by the Administrator.

Some of the more significant questions and issues raised are listed below.

- What are the most appropriate measures of industry profitability at the segment and firm level and what is the most appropriate standard against which to evaluate the adequacy of the profits?
- What criteria should be used to assess the success of the profit policy?
- What is the best basis for evaluating profitability of non-capital intensive firms?
- How should industries be classified in order to recognize inherent differences among the various types of firms and segments?
- What is the best time of the calendar year for companies to prepare and submit the required financial data?
- Would it be desirable for some companies to consolidate reports for all or several of their Cost Accounting Standards Board segments?
- What specific companies or classes of companies should be excluded from reporting under the exemption provision of the bill?

Agencies, Contractors, and Other Parties That Were Visited or Provided Written Comments on the PRP Proposal(*)

Government Contractors:

AEL Industries, Inc. Lansdale, Pennsylvania *
Aeroquip Corporation, Jackson, Mississippi *
Bendix Aircraft Systems Company, Arlington, Virginia *
The Boeing Company, Seattle, Washington *
Burroughs Corporation, Detroit, Michigan *
Dynalectron Corporation, McLean, Virginia *
Eastman Kodak Company, Rochester, New York *
Emerson Electric Company, St. Louis, Missouri *
Fairchild Industries, Inc., Chantilly, Virginia *
Fairchild Weston Systems, Inc., Sarasota, Florida *
FMC Corporation, Chicago, Illinois *
General Dynamics Corporation, St. Louis, Missouri *
General Electric Company, Fairfield, Connecticut *
General Motors Corporation, Detroit, Michigan *
Grumman Corporation, Bethpage, New York *
Hazeltine Corporation, Commack, New York *
Hewlett-Packard Company, Palo Alto, California *
Litton Industries Incorporated, Beverly Hills, California *
Lockheed Corporation, Calabasas, California *
Martin Marietta Corporation, Bethesda, Maryland *
McDonnell Douglas Corporation, St. Louis, Missouri *
Morton Thiokol, Inc., Chicago, Illinois *
Motorola, Inc., Arlington, Virginia *
Paccar, Inc., Bellevue, Washington *
Raytheon Company, Lexington, Massachusetts *
RCA Corporation, Fairfield, Connecticut *
Rockwell International Corporation, Pittsburgh, Pennsylvania *
Rolls-Royce plc, Bristol, England *
Sun Chemical Corporation, Merrimack, New Hampshire *
Sun Company, Inc., Radnor, Pennsylvania *
Texas Instruments Incorporated, Dallas, Texas *
Textron, Inc., Providence, Rhode Island *
Westinghouse Electric Corporation, Pittsburgh, Pennsylvania *

Industry Associations and Others:

Aerospace Industries Association of America, Inc., Washington, D.C. *
Robert N. Anthony, Waterville Valley, New Hampshire *
Chamber of Commerce of the United States of America, Washington, D.C. *
Computer and Business Equipment Manufacturers Association, Washington D.C. *
Council of Defense and Space Industry Associations, Washington, D.C. *
Electronic Industries Association, Washington, D.C. *
Financial Executives Institute, Washington, D.C. *
Machinery and Allied Products Institute, Washington, D.C. *
National Security Industrial Association, Washington, D.C. *
Procurement Round Table, Washington, D.C. *
Professional Services Council, Washington, D.C. *
RRG Associates, Arlington, Virginia *

(continued)

Appendix I
Agencies, Contractors, and Other Parties
That Were Visited or Provided Written
Comments on the PRP Proposal(*)

Federal Agencies:

Department of Commerce, Washington, D.C.
Bureau of Economic Analysis, Department of Commerce, Washington, D.C.
Bureau of Census, Department of Commerce, Washington, D.C.
Department of Defense, Office of the Assistant Secretary (Acquisition and Logistics),
Washington, D.C.
Defense Contract Audit Agency, Department of Defense, Cameron Station, Alexandria,
Virginia
Defense Systems Management College, Fort Belvoir, Virginia
Department of Transportation, Washington, D.C.
Bureau of Labor Statistics, Department of Labor, Washington, D.C.
General Services Administration, Office of Acquisition Policy, Washington, D.C.
National Aeronautics and Space Administration, Washington, D.C.
Office of Federal Procurement Policy, Office of Management and Budget, Washington, D.C.
Federal Trade Commission, Washington, D.C.
Securities and Exchange Commission, Washington, D.C.

Federally Funded Research and Development Center:

Logistics Management Institute, Bethesda, Maryland

Public Accounting:

Touche Ross and Company, Washington, D.C.
American Institute of Certified Public Accountants, Washington, D.C.
Ernst & Whinney, Cleveland, Ohio

Consultants:

Rear Admiral Stanley S. Fine (Ret.), McLean, Virginia, Former Budget Officer, Headquarters
U.S. Navy
Mr. Robert C. Moot, Annandale, Virginia, Former Assistant Secretary of Defense
(Comptroller)
Mr. Tom Morris, Bethesda, Maryland, Former Assistant Secretary of Defense (Installations &
Logistics)
Mr. Barry Shilito, La Jolla, California, Former Assistant Secretary of Defense (Installations
& Logistics); Former President of LMI

Government Contractor Profit Reports Act of 1987

A Bill

To improve Federal Government accountability over profits made by contractors under federal contracts by requiring periodic profitability studies, among other things.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

Short Title

Sec. 1. This act may be cited as the "Government Contractor Profit Reports Act of 1987."

Declaration of Purpose

Sec. 2. It is the policy of the Congress that the procurement of goods and services by the Executive Branch of the Federal Government be conducted in an economical, efficient, and effective manner. This policy can be fulfilled only if the Congress and the executive agencies are informed of the level of profits and efficiency of government contractors. The purpose of this act is to provide the Federal Government with the information needed to develop profit policies and to assist procuring agencies in negotiating contracts which (1) provide profits that encourage related capital investment and (2) are reasonable in light of, among other things, the profits contractors earn on other government and similar private sector business.

Sec. 3. Definitions

In this act—

(1) "Administrator" means the individual designated by the President to implement the provisions of this act

(2) "covered company" means a company which received for two consecutive years government contract awards and modifications for which certified cost or pricing data was required, or receives payments, for two consecutive years from the federal government under such contracts, the total of which amounts to at least \$50 million in a year. A

company will remain a "covered company" until its government business is less than the qualifying level for two consecutive years.

(3) "segment" means a division, product department, plant, or other subdivision of a covered company usually identified with responsibility for profit and/or producing a product or service; and reports directly to an office of the company which (i) is responsible for directing or managing two or more divisions, product departments, plants or subdivisions, and (ii) typically provides policy and guidance to segments in their operations. A covered company is, for the purpose of this act, considered a segment if it is not segmented.

Sec. 4. Responsibilities of the Administrator

(a) The Administrator shall—

- (1) develop a uniform reporting system to govern the submission of information by Government contractors under section 5 of this act;
- (2) establish criteria and procedures for the profit studies to be conducted under section 6 of this act; and
- (3) provide recommendations to revise and develop profit policies relating to the negotiation of Government contracts.

(b) Notwithstanding section 3(2), the Administrator by regulation—

- (1) may exclude classes of Government contractors from coverage as a covered company if the Administrator determines that, based on the nature of the class or the types of products and services provided by it, coverage of such class will not contribute to the purposes of this act; and
- (2) may revise the dollar threshold contained in section 3(2) as the Administrator deems necessary to fulfill the purposes of this act. Revisions to the dollar threshold shall be designed to ensure that the total value of all contracts that were awarded by the federal government to the companies covered under the revised threshold is at least 60 percent of the total value of all contracts awarded by the Federal Government.

(c) The Administrator is authorized to contract with a firm or organization, and to enter into an agreement on a reimbursable basis with an agency, for services to assist the Administrator in carrying out the requirements of this act.

Sec. 5. Annual Reporting by Covered Companies

(a) A covered company shall annually transmit to the Administrator balance sheet and income statement information reflecting the financial position and operations of each of its segments which contributes to the revenues the company received in the preceding year from contracts for which certified cost or pricing data was required, and such accompanying information as may be required, including investment data and labor expenses. A covered company shall report for each segment the required financial information in a manner which distinguishes between the information related to its Government contracts for which certified cost and pricing data was required and the information related to all of its other business. The information transmitted shall include a reconciliation with the financial statement the covered company filed with the Securities and Exchange Commission, and such other information as may be necessary to explain the reconciliation. For privately held companies information transmitted shall include a reconciliation to audited financial statements.

(b) The Administrator shall prescribe by regulation the information required by subsection (a). A company shall provide the information in such form and at such time as the Administrator requires. A covered company may request that the requirement in subsection (a) for the company to report information for each of its segments be waived for any segment which contributed less than 10 percent of the revenues the covered company received in the preceding year from contracts for which certified cost or pricing data was required. The Administrator shall grant the request if the Administrator determines that the information concerning the segment for which a waiver is requested would not substantially contribute to the analysis required by section 6. The Administrator shall not require a company to report information for a segment to the extent the President determines that disclosure of such information would be detrimental to the success of a classified project and injurious to the national security. The Administrator shall identify all waivers granted under this subsection in the annual report required by section 7 of this act.

(c) A covered company shall have an independent certified public accountant report on the reliability of the information furnished under subsection (a). A covered company shall include the report by the independent certified public accountant in the transmittal to the Administrator required by subsection (a).

(d) The Administrator shall prescribe standards and procedures for the report required by subsection (c).

(e) The Administrator, in coordination with the Office of Federal Procurement Policy, shall take the necessary steps to ensure that compliance with the requirements of this section is a condition of every contract negotiated with the United States.

Sec. 6. Profit Study Requirements

(a) The Administrator shall conduct at least once every 3 years a study of profits made by covered companies under contracts for which certified cost or pricing data is required.

(b) Based on an aggregation of the information provided under section 5, a study shall contain a determination of the profitability of segments of covered companies providing the Federal Government with goods and services under negotiated government contracts for which certified cost or pricing data is required. Profitability shall be determined by calculating the return on assets of the segments and by such other measures of profitability as the Administrator determines to be appropriate to achieve the purposes of this act.

(c) The study shall provide a comparison of the profitability of the segments, as determined under subsection (b), with—

(1) the profitability of the segments under all of their other business; and

(2) the general profitability of other companies in the private sector for similar goods and services.

(d) To the extent applicable, the study shall include analysis of—

(1) whether variations between the levels of profitability are reasonable under the circumstances;

(2) capital investment and the relative investment between the covered companies' government business from contracts for which certified cost or pricing data is required and their other business;

(3) the use of pricing to motivate cost efficiency and the relative efficiency between the covered companies' government business from contracts for which certified cost or pricing data is required and their other business;

(4) the relationship of payment policy and contract pricing; and

(5) any other information useful to understanding the comparisons required by subsection (c).

(e) In addition to the information provided under section 5, a covered company shall provide to the Administrator any additional information the Administrator determines is necessary to make the determinations and perform the analysis required by this section.

Sec. 7. Profit Study Reporting

No later than December 31 of each year, the Administrator shall transmit a report to the President, the Congress, and the Comptroller General of the United States. The report shall identify any studies conducted in the preceding fiscal year, the relationship of the findings resulting from such studies to existing profit policies, and any actions taken or to be taken relating to the responsibilities of the Administrator under this act.

Sec. 8. Access to Information

The Administrator shall have access to all papers, documents, and records of a covered company and its independent certified public accountant relating to the information furnished under sections 5 and 6(e). The covered company and its independent certified public accountant shall permit the Administrator to make and retain copies of such papers, documents, and records, and shall make available such officers and employees as the Administrator requests.

Sec. 9. Comptroller General Review

The Comptroller General is authorized to review a profit study conducted under section 6 and shall have access to all papers, documents, and records of the Administrator used in conducting the study, and of the company and its certified public accountant used in providing the information required under sections 5 and 6(e). The Administrator, covered company, and its independent certified public accountant shall permit the Comptroller General to make and retain copies of such papers, documents, and records, and shall make available such officers and employees as the Comptroller General requests.

Sec. 10. Confidentiality

Notwithstanding any other provision of law—

(1) Any officer, employee, or contractor of the Administrator or the General Accounting Office who publishes or otherwise discloses any information provided by a covered company under section 5 or section 6(e) in a manner which allows the covered company to be identified to any individual or establishment not specifically authorized by this act to receive such information, shall be fined not more than \$10,000, or imprisoned not more than three years, or both,¹ unless such information is made publicly available by the covered company.

(2) No person receiving information provided by a covered company under section 5 or section 6(e) shall be subject to subpoena or other legal process to compel disclosure of information which is prohibited by paragraph (1)

Sec. 11. Authorization of Appropriation

There is authorized to be appropriated to the Administrator such sums as are necessary to carry out this act.

¹The penalties included in section 10 are for illustrative purposes.

Proposed Form for Contractor Reporting of Financial Data

United States Government Contractor's Annual Reporting Form
Schedule I - Selected Income Statement Items for the Period Ended _____, 19__
(In Thousands of Dollars)

Corporation Name: _____
 Segment Name: _____
 Segment's Major Products Identified By 4 Digit Standard Industrial Code: Number 1 _____ Number 2 _____
 Percentage of Government Sales By Federal Agency:
 Number 1 _____ Number 2 _____ Number 3 _____ Number 4 _____ Number 5 _____
 Percentage of Government Sales Prime Contracts: _____ Percentage of Government Sales Subcontracts: _____

Profit Reporting Program

Government-Wide Contracts* Based on Cost and Pricing Data

Line No.	Financial Information	Cost	Fixed	Other**	Segment Total	Footnote
		Type	Price Type			
		(1)	(2)	(3)	(4)	(5)
01	<u>Sales</u>					
	Cost of Sales and Operating Cost:					
02	Cost of Sales					
03	Other Allowable Operating Costs					
04	Total Operating Costs (Lines 02 + 03)					
05	Net Operating Results on Allowable Costs (Lines 01 - 04)					
	Unallowable Costs					
06	Interest					
07	Other Unallowable Costs					
08	Total Unallowable Costs (Lines 06 - 07)					
09	Net Operating Results on Total Costs (Lines 01 - 04 - 08)					
	Statistical Information					
10	Depreciation and Amortization Expense: (Memo Entry)					
	Labor Costs: (Memo Entry)					
11	Segment Labor Costs					
12	Number of Employees					
	CAS 414 Cost of Money: (Memo Entry)					
13	Total Imputed Cost of Money					
14	Amount Eligible					
15	Amount Not Eligible					

*Sales under procurements related to U.S. Government prime contracts and subcontracts under either fixed price or cost type contracts. Foreign Military Sales that are direct sales to U.S. Government made under negotiated contracts for eventual resale to a foreign government are included.

**Sales to customers other than the U.S. Government plus sales to the U.S. Government which are not based on cost or pricing data, such as catalog or established market price items, sales of items whose prices are established by law or regulation, sales made under sealed bids, and direct sales to foreign governments are included and all other sales not included in columns (1) and (2).

**Appendix III
Proposed Form for Contractor Reporting of
Financial Data**

United States Government Contractor's Annual Reporting Form
Schedule II - Selected Balance Sheet Items for the Period Ended _____, 19__
(In Thousands of Dollars)

Corporation Name: _____

Segment Name: _____

Line No.	Financial Information	Profit Reporting Program				Footnote
		Cost Type	Fixed Price Type	Other**	Segment Total	
		(1)	(2)	(3)	(4)	(5)
	Account Receivable (Gross)					
01	Billed	_____	_____	_____	_____	_____
02	Unbilled	_____	_____	_____	_____	_____
	Inventories (Gross)					
03	Common	_____	_____	_____	_____	_____
04	Contracts in Process	_____	_____	_____	_____	_____
05	Total Accounts Receivable and Inventory (Gross) (Lines 01 + 02 + 03 + 04)	_____	_____	_____	_____	_____
06	Less: Progress Payments and Advancements	_____	_____	_____	_____	_____
07	Net Accounts Receivable and Inventory (Lines 05 - 06)	_____	_____	_____	_____	_____
08	Other Current Assets					
09	Total Current Assets (Lines 07 + 08)	_____	_____	_____	_____	_____
	Tangible Fixed Assets (Facilities Capital):					
10	Equipment: Net Book Value	_____	_____	_____	_____	_____
11	Building: Net Book Value	_____	_____	_____	_____	_____
12	Land and Land Improvements: Net Book Value	_____	_____	_____	_____	_____
13	Total Contractor Owned Tangible Fixed Assets (Facilities Capital Lines 10 + 11 + 12)	_____	_____	_____	_____	_____
14	Intangible Assets: Net Book Value					
	Total Assets	_____	_____	_____	_____	_____
	Statistical Information					
15	Construction in Progress (Memo Entry)	_____	_____	_____	_____	_____
	Segment Capital Expenditures (Memo Entry)	_____	_____	_____	_____	_____
16	Equipment	_____	_____	_____	_____	_____
17	Building	_____	_____	_____	_____	_____
18	Land and Land Improvements	_____	_____	_____	_____	_____

*Sales under procurements related to U.S. Government prime contracts and subcontracts under either fixed price or cost type contracts; Foreign Military Sales that are direct sales to U.S. Government made under negotiated contracts for eventual resale to a foreign government are included.

**Sales to customers other than the U.S. Government plus sales to the U.S. Government which are not based on cost or pricing data such as catalog or established market price items, sales of items whose prices are established by law or regulation, sales made under sealed bids and direct sales to foreign governments are included and all other sales not included in columns (1) and (2).

Proposed Profit Policy Analysis Plan

I. Introduction

This appendix briefly discusses a suggested methodology for analyzing the relative profitability and efficiency of U.S. government contractors. Both the requirements of the proposed legislation and the proposed contractor reporting forms included as appendix III are incorporated in this discussion.

II. Purpose of the Legislation

This legislation is intended to enable the PRP Administrator to measure the relative profitability and efficiency of U.S. government contractors. The results of the periodic profit/efficiency studies performed by the Administrator could then be used to assess the effect of the profit (payment) policies of the U.S. government.

The primary goals of each executive agency's profit policy are to provide a competitive rate of return to contractors that would neither be too high resulting in unnecessary expenditures, nor too low which would discourage firms from seeking U.S. government business. Also, the policy should seek to provide incentives to contractors to become more efficient by investing in cost-saving equipment, thereby minimizing the total cost of each contract to the government.

III. Requirements of Legislation (Profitability)

Section 6 of the proposed legislation provides a list of the "Profit Study Requirements." Specifically, "profitability shall be determined by calculating the return on assets" of covered companies providing the federal government with goods or services under negotiated government contracts. Section 6 also authorizes the Administrator to use such additional measures of profitability as deemed appropriate. Furthermore, the profitability of "government" business will be compared with that of "commercial" business of these contractors as well as with the profitability of other companies in the private sector that are supplying similar goods and services.

These calculations are performed to permit a comparison between the rate of return being realized on non-competitive negotiated government contracts with those earned in the competitive environment of the commercial marketplace

IV. Analytical Framework - Profitability

A. Selection of ROA Measure

A study of how government contractor profits compare with those of non-government firms or segments requires (1) a meaningful measure of profitability and (2) a standard against which the measure of profitability of government contractors can be compared. (The term profitability represents a measure of rate of return calculated by dividing profits by a base such as sales, assets, or equity.)

The standard measures of profitability that have been used most frequently in studies of this type are: return on sales and return on investment. Since all firms compete for funds in the capital markets, and these funds are likely to be attracted to those opportunities offering the highest expected rates of return, the preferred measure of profitability would be a return on investment standard. There are two ways to raise capital, that is by issuing debt and by selling equity shares. One frequently used return on investment measure is the return to equity. The other, ROA, represents the return to total assets whether acquired by debt capital or equity capital.

The use of return on sales as a measure is less desirable than the return on investment measures since it is a profitability measure based on output, and not input or how effectively a firm invests its capital. As mentioned above, since firms compete for funds in the capital markets, investors (individuals and institutions) are concerned with the rate of return on their investment, which is an input measure to the firm. A rate of return on sales is less likely to be related to a return on an investor's capital but more to the products being sold, or the specific industry. For example, retail food stores generally earn a relatively low return on sales, but an average return on invested capital. Thus, a return on sales comparison across industries would appear to be of questionable value. On the other hand, comparing return on sales among firms in the same industry may, in this limited case, provide useful information of the relative profitability of those firms.

One can use return on equity or after tax accounting profits divided by shareholder equity for firm level comparisons. However, since there is no generally accepted method for allocating either equity or taxes to the

segment level, the return on equity measure cannot be used to make segment level comparisons in the context of PRP.

Finally, with respect to the other return on investment measure of profitability, ROA, profits would be divided by the book value of the segment's total assets. Since both the numerator and denominator for this return on investment computation at the segment level are available from the contractor reported data, the ROA measure of profitability is recommended as the principal measure of rate of return in PRP.

B. Calculation of ROA

The profitability of negotiated contracts can be calculated from the contractor reporting forms: "Schedule I—Selected Income Statement Items" and "Schedule II—Selected Balance Sheet Items." (See app. III.)

For each reported segment, the ROA computation can be performed by dividing the sum of line 09 (net operating results on total costs) and line 06 (interest) of schedule I by the sum of line 09 (total current assets), and line 13 (net book value of contractor owned tangible fixed assets at the segment) of schedule II. [Interest payments are added to the numerator to permit a comparison of profitability between firms without regard to the amount of debt (versus equity) financing used by the firm. Thus, the total return to capital (investment) is calculated. Finally, net operating results are computed by subtracting the sum of the cost of sales (line 02), other allowable cost (line 03), and total unallowable cost (line 08) from sales (line 01) of schedule I.] To calculate net operating results for government contractors based on allowable costs only, total operating costs (line 04) may be subtracted from sales (line 01) of schedule I.

It is important to note that in computing a firm's total assets for the denominator of the ROA calculation, "progress payments and advances" (line 06 of schedule II) is subtracted. This is appropriate since progress payments represent assets of the U.S. government and not assets of contractors. It has been recommended that progress payments be included in the asset base to compare profitability of government business with commercial business, the methodology used by DFAIR. We do not consider that appropriate because progress payments do not represent investment by the contractor, thus, including progress payments in the assets obscures the financial benefit of this government policy and precludes an analysis of payment policy effect on profitability.

The above methodology, which has total assets in the denominator and measures the return to all assets used in contract performance in a segment is the most widely used approach to calculate ROA. Another methodology which incorporates net assets (total assets minus current liabilities) and measures the return to permanent capital invested in the segment has been suggested to calculate ROA. However, additional data at the segment level (e.g., current liabilities) would have to be identified and collected in order to perform this calculation. Furthermore, this measure can lead to results that depend largely on the extent of short-term financing that is used by each firm. The more short-term debt a firm incurs, the greater will be the subtraction from its total assets, and therefore, the higher its calculated ROA. For these reasons we prefer the conventional measure of ROA which calculates a return to all funds invested in the firm exclusive of progress payments.

The contractor data also permit a comparison of the profitability of "cost-type" contracts (column 1) with "fixed-price" contracts (column 2). Since fixed-price contracts present a higher risk to contractors than do cost-type contracts, one would expect to observe higher rates of return on the former in order to compensate contractors for the higher risk.

Each segment's major products will be identified by the 4-Digit Standard Industrial Codes.¹¹ Therefore, some comparisons of profitability between government business and non-government business can be performed by product class.

Additional comparisons of the profitability of government contracts versus non-government work may also be performed by examining the pre-tax (a) of non-defense durable goods manufacturers by using the Compustat data base, as well as the Quarterly Financial Report published by the U.S. Commerce Department.

The Compustat data base is available on an annual basis from the Standard & Poor's Corporation. It contains income statement and balance sheet data for over 1,000 companies at both the firm level and Securities and Exchange Commission segment level. However, the Securities and Exchange Commission segments are not as precisely defined as Cost Accounting Standard Board segments. The Quarterly Financial Report presents estimated statements of income and retained earnings, balance sheets, and related financial and operating ratios for all manufacturing, and trade corporations. The statistical data are classified by industry and asset size.

It should be noted that if some firms, such as service contractors, have a very small asset base which would result in a ROA that would not be meaningful, then the Administrator may separately analyze these firms by using the return on sales or other appropriate measures.

Section 6(d)(1) of the proposed legislation requires the determination of whether variations between levels of government business and non-government business profitability are reasonable. These variations can refer to (1) differences between the profitability of government and non-government business in a given year as well as over several years and (2) variations (as measured by the standard deviation) of profitability over time by firm to measure the relative risk of government versus non-government business. Since investors tend to dislike risk and will demand a higher rate of return from firms facing greater risk, profit comparisons might be misleading without a risk measure being considered.

V. Requirements of Legislation (Investment— Efficiency)

Section 6(d) of the proposed legislation states:

“To the extent applicable, the study shall include an analysis of . . . (2) capital investment and the relative investment between the covered companies’ government and commercial business” and “(3) the use of pricing to motivate cost efficiency and the relative efficiency between the covered companies’ government and commercial business.”

Section 6(d) (2) and (3) enable contracting agencies to examine what effect changes in contract pricing and investment incentives are having on the amount and the type of assets being acquired. The results of this analysis can be used to modify payment policy and contract pricing policies. The Administrator can use the results of these studies to recommend alterations to profit policies in order to encourage additional cost-saving investment.

Analytical Framework (Investment— Efficiency)

A. Selection of “Capital- To-Labor” Ratio

Concern has been expressed as to whether the U.S. government’s contract pricing, financing, and profit policies are encouraging contractors to operate in the most efficient manner. Put differently, are government contractors satisfying the procurement needs of federal agencies at minimum total cost? The question is too complex to be answered directly; instead, it must be approached by looking at indirect or intermediate measures of contractor behavior. In effect, the debate focuses on the validity of an alternative hypothesis about (1) whether past government contracting and profit policies might have encouraged inefficient production methods and (2) whether recent changes in these policies are likely to lead to behaviors that are closer to those desired.

Although efficiency cannot be precisely defined and measured, one approach that is suggested examines the relative amount of investment or capital in manufacturing enterprises.

Specifically, the relative use of capital and labor, or capital intensity, may be a useful indicator of efficiency. To make judgments about the relative use of capital and labor by government contractors, consideration should be given to (1) an ideal measure of capital intensity, (2) a meaningful measure of capital use, and (3) a standard against which the measure of capital intensity for government contracts can be compared.

An ideal measure of the capital intensity of a specific line of business is the capital-to-labor ratio (k/l). Theoretically, capital would be measured by the market value of the property, plant, and equipment of a line of business. Given the unavailability of these data, capital could be represented by the book value of “net property, plant, and equipment” associated with that line of business. Similarly, “total labor expenses” would ideally be used as a measure of “ l ” by line of business. If commercial durable good manufacturing lines of business of government contractors use similar technologies as the government work, and these non-government lines are disciplined by the marketplace to operate in the most efficient manner (i.e., produce at minimum cost), a calculation of k/l for these lines would provide a standard or benchmark for an optimal k/l ratio. A comparison of the capital intensity measure for government

business with other closely related lines of business would, therefore, provide an indication of whether government contractors are using their factor inputs of capital and labor in approximately the same ratio. If K:L for government work is significantly below that for commercial work, this would suggest that the contractor may not be facing the proper incentives to minimize cost by incorporating the same K:L mix that is used in commercial work.

It is important to note, however, that where possible, several adjustments, should be made to the K:L calculations. First, contractors frequently use government-owned facilities. For a more precise analysis it would be necessary to estimate a book value for these facilities and then include the estimate in the calculation of capital for that firm. Second, the K:L ratio may vary by product mix. That is, the production process for some equipment is less capital intensive than others. Therefore, it would be of interest to compare K:L ratios across contractors to establish whether there is a wide variance in this measure. If there is a large dispersion in K:L values (holding contract type constant) then there would be an indication that products and the technologies required to manufacture them are too heterogeneous to be lumped into the same category. For example, optimal K:L ratios may differ greatly in the production of aircraft versus the manufacture of defense electronics. This problem would raise questions as to the use-fitness of overall K:L comparisons across firms.

A third concern that should be examined is the "capacity utilization" of a firm's capital. For example, if firm A and firm B are identical in all respects except that firm A uses its capital during one 8-hour shift a day, while firm B hires additional labor for a second 8-hour shift, the K:L ratio for firm B would be lower than that of firm A (unless an appropriate adjustment is made).

Thus, before K:L ratios can be properly calculated and compared across firms, industries, and time, one should control for each of the above concerns.

It should also be noted that the primary reason for preferring a K:L ratio to a capital-to-sales ratio is that the former provides a measure of the relative use (and, therefore, efficiency) of two inputs (capital and labor), while the latter is a ratio of an input (capital) to output (sales). Furthermore, sales do not depend solely on input costs, but also on the price received for the end products.

B. Calculation of K/L Ratio

The K/L for government contractors may be calculated from "Schedule I—Selected Income Statement Items" and "Schedule II—Selected Balance Sheet Items." For each reported segment, the K/L computation can be performed by dividing the sum of line 13 (net book value of contractor owned tangible fixed assets at the segment) of schedule II by line 11 (segment labor costs) from schedule I.

The individual segment K/L calculations can be aggregated by Standard Industrial Classification code (from columns (1) and (2)) and compared with the K/L ratio of other work performed by government contractors (column 3).

Finally, the asset breakdown on schedule II by net book value of equipment (line 10), buildings (line 11), and land (line 12), permits an analysis of the effect changes to profit policy have on the type of fixed assets acquired by the contractor. A consistent methodology should be used to allocate these assets within the segment. Cost accounting standard 414 techniques can be used as a basis for developing such a methodology.

This classification of assets also helps the comparison between types of investment undertaken for government versus non-government business.

VI. Limitations

The ROA measure is sensitive to the accounting methodology used by each firm. The denominator of this ratio represents the book value of a segment's assets. However, the book value is a function of which depreciation method (accelerated or straight line) is used by the firm as well as by the age of these assets. An alternative, conceptually preferred measure for book value is the "market value" of the assets. Since the market value of assets is generally not available, this measure cannot be used. Thus, despite its potential shortcomings, financial analysts and accountants generally use the book value of assets in their ROA calculations.

VII. Conclusions

The performance of periodic profit studies using the contractor data as outlined above would permit policymakers to determine how the relative profitability and efficiency of government contractors has changed over time. This analysis would enable the PAP Administrator to examine the effect of changes in profit policy on both the profitability and investment of government contractors.

The analyses outlined in this appendix will permit the determination of whether variations between levels of government and other business profitability are reasonable. Moreover, section 6(d)(3) of the bill can also be used to determine "the use of pricing to motivate cost efficiency and the relative efficiency between the covered companies' government and commercial business." Contracting agencies can examine what effect changes in contract pricing and investment incentives are having on the amount and type (equipment, buildings, land) of assets being acquired. Finally, the results of this analysis can be used to modify payment policy and contract pricing policies (section 6(d)(4)). The Administrator can use the results of these studies to recommend alterations to profit policies in order to adjust the profitability of government business as well as encourage additional cost-saving investment.

In November 1986, we issued for general comment an exposure draft outlining our proposal for a program to study the profitability of government contractors. Federal agencies, contractors, and others that we consulted while developing our proposal, as well as other interested parties, were asked to provide written comments on the draft.

A law required as a matter of law is generally viewed by government contractors as another level of unnecessary and potentially damaging government oversight. Unnecessary because many believe that will continue to conduct ad hoc studies of contractor profitability as it has twice done since 1976, and potentially damaging because of the possible disclosure by federal employees, of individual company proprietary financial information provided for profitability studies. To some federal officials, contractors, and private associations substantive questions remain to be answered before profit reporting legislation is presented to the Congress.

This appendix summarizes the respondents' comments and outlines our position on the points raised.

Need for PRP

Respondents questioned the need for a PRP. Defense contractors and industry associations believe that ad hoc profitability studies are adequate to determine if profit policy goals are being achieved. DOD believes we should acknowledge its existing management information system on profit.

Quotes From Comments

"GAO's proposed profit reporting system provides no advantages over existing practices. Legislation should be used to solve problems where executive agencies have shown an unwillingness to accept appropriate responsibility. Such a need is clearly not evident for profit reporting legislation."

"One might suspect that the real motive behind the proposed program is to reduce contractor profits to the minimum level which will still maintain a sound industrial base through the running of pre-venture profit objectives."

"There are several problems that should be more completely evaluated by the GAO before a proposal is submitted to the Congress. The value-added is questionable.

Government Contracting: A Proposal for a Program to Study the Profitability of Government Contractors (GAO/NSI/MFR-87-175, Nov. 1986)

**Appendix V
Summary of Comments: Contractors,
Industry Associations, Federal Agencies,
and Others**

since a number of significant profit and contract financing studies were conducted by the DOD over the years without a legislative requirement to do so.

These and similar comments do not address the most basic reason we believe a PRP is needed. That is, there is presently no requirement to study profitability of both DOD and civil agency contractors on a regular systematic and consistent basis. In our opinion, without a legislated underpinning for a PRP for future studies, profit studies will likely be performed as they have been in the past, i.e., infrequently on an ad hoc basis, relying on voluntary contractor participation, and changing analytical methodologies from study to study.

DOD accurately points out that since 1964 it has had a system to obtain information on profits. DOD's system contains information on prenegotiation profit strategies and summarizes information on negotiated results, in other words, "going-in" profits on an individual contract basis. Except for data obtained to perform its ad hoc profit studies, DOD has no information to measure profit levels actually earned by contractors or classes of contractors as a result of performing government contracts.

The goal of the PRP is to obtain better information to develop and revise profit policy. Such information could help government officials reach decisions to either increase or decrease profit objectives.

Program Cost Versus Benefits

Respondents said we had not demonstrated that a PRP would produce benefits in terms of dollars and cents that outweigh the costs of implementing and operating such a program.

Quotes From Comments

"... is the cost of the program justified in comparison to the cost of occasional ad hoc studies?"

"... the proposal should include a credible cost-benefit assessment."

The benefits to be derived from a PRP are not quantifiable. PRP will provide better information than has previously been available to help government managers develop and revise profit policies.

Cost estimates to provide PRP data, as submitted by respondents, ranged from \$25,000 per segment to \$700,000 per segment per year, not including CPA fees. The large difference between the costs estimates supports the view that costs cannot be reliably estimated until detailed PRP procedures are promulgated and companies can better evaluate the effect of PRP on their accounting and financial reporting systems.

The costs to the government and to the contractors for individual PRP studies may, in the long term, be less than the costs incurred to perform DEAIR. The segment level data we are recommending contractors provide is less than required for DEAIR. These data are not unique or unusual, and should readily flow from the contractors accounting system. After initial start-up costs to develop a systematic method to allocate costs and assets to cost type and fixed-price type government contracts, costs should decline.

While costs are obviously a consideration it would be surprising if the cost difference between the ad hoc approach for individual studies and individual PRP studies is significant. But more important a PRP will eliminate the current uncertainty concerning profitability levels of government business by providing accurate and reliable data so that government contracting agencies would routinely know the effect of their profit policies.

We believe that the Administrator with a limited staff and contract authority should be able to administer the program with minimal resources, similar to those employed by the Logistics Management Institute. The Logistics Management Institute performed studies for DOD with three full-time professional staff members, supplemented with some contractor support.

Executive Branch Responsibilities

Respondents viewed the Office of Profit Studies and Analysis as a new federal bureaucracy with unnecessarily broad powers created to develop a centralized government profit policy.

Quotes From Comments

"The GAO proposal would shift key decisions on profit from departmental experts with day to day procurement responsibility and experience to a new bureaucracy with no accountability for program and contract success."

“Creation of profit policy and the measurement of its success must be left to the discretion of the procurement agencies whose missions and procurement markets will necessarily vary from each other.”

“If a uniform means of studying profits is necessary, a centralized agency to perform those studies is certainly not. Either the President or Congress could direct the agencies to establish a mechanism for studying profits, setting forth the criteria and methodologies for the studies in whatever manner may be appropriate. Thus, all agencies could be required to accomplish their studies through the same methodology, and with comparable data bases, without creating an expensive new bureaucracy to do the same job.”

In the exposure draft we recommended that an Office of Profit Studies and Analysis be established to administer PEP. Contrary to the perception of respondents, we are not advocating a new federal agency either to oversee the program or to formulate or revise profit policy. To clarify the nature of the program, we have revised the draft legislation to provide the President designate an Administrator, rather than a separate office to implement the PEP. Because the Office of Federal Procurement Policy has overall responsibility for formulating government procurement policy, we believe the Office of Federal Procurement Policy Administrator would be an appropriate individual to implement PEP.

If the PEP was assigned to the Office of Federal Procurement Policy, the responsibility for making or revising profit policy will continue to rest with the executive agencies and not be delegated to the Office of Federal Procurement Policy Administrator. To perform the studies required to address the long-term effect of profit policy, the Administrator should have the flexibility necessary to revise the analyses to be performed as conditions change.

Covered Companies

Respondents suggested changing the criteria for covered companies and segments. They believe that criteria of \$50 million in negotiated contracts would result in coverage which would be too broad. Some interpreted the language of the proposed legislation to require reporting of data for segments doing solely commercial business. They argued that companies should meet the criteria for 2 or 3 consecutive years to minimize the problem of including contractors whose government business does not consistently meet the reporting criteria.

Quotes From Comments

"... the definition of 'covered company' is too broad. Companies that sell primarily in the commercial marketplace should not be burdened with this additional reporting requirement simply because the government also buys the company's commercial products."

"Dramatic cost reduction may be possible by limiting the coverage to the largest government contractors comprising at least 60 percent of the dollar value of all noncompetitively negotiated contracts rather than to contractors whose total contract awards amount to \$50 million annually."

"Sec. 5 requires that covered companies submit data on all segments, whether or not the segments had any government business, unless a specific waiver is obtained. This approach is very impractical."

We suggest two or three consecutive years experience (above the threshold) would be appropriate before becoming eligible—thereby minimizing in-and-out reporting situations.

We agree with the concerns raised and have changed the coverage criteria from \$50 million of negotiated contracts in a year to \$50 million for 2 consecutive years of negotiated contracts where certified cost or pricing data is required. (See page 23.) Segment reports would be required when a segment does 10 percent of the company's business based on negotiated contracts where certified cost or pricing data is required. (See page 24.)

No segment doing solely commercial work would be required to report. For profit reporting purposes commercial work classified as "other" in the reporting forms includes government sales which are not based on cost or pricing data, such as catalog or established market price items and sales under sealed bids. (See app. III.)

Analysis and Methodology

606), and to a large extent, the contracting community and industry associations endorse the methodology devised for DEAIR to compute a ROA for government contractors. They question the validity of comparing the relative profitability of government contractors, and suggest that comparing the profitability of government business with commercial business is not realistic.

Quotes From Comments

"We recommend the adoption of the DEAIR analytical tools as the standard measures for use in future profit studies."

"Much of the goods and services provided to the government do not compare with goods and services provided by companies in the private sector. Therefore, profitability comparisons for many large dollar items may not be analytically sound."

"The true profitability of a company cannot be measured in a single year. You have to know whether over a period of time the company has an adequate ROI on its major programs. Defense programs may require years of investment with ROI being long deferred."

"In all likelihood, Federal agencies will respond to the use of a return-on-assets measure of profitability by restructuring their own profit calculations to place greater emphasis on return on assets. . . measuring profitability and efficiency in this fashion might result in less contractor emphasis on cost control and more emphasis on expanding the investment base, which may not be in the government's best interest."

" . . . the draft recommends use of a capital to labor ratio for measuring productivity. We recognize the desirability of measuring productivity and the validity of DOD initiatives to encourage investments which enhance productivity. However, the GAO technique for measuring productivity is misguided because it fails to recognize the inconsistencies between companies and industries."

We disagree with the methodology used in DEAIR to compute profitability of government business. DEAIR added the value of the government's progress payments to the companies asset base which lowered their ROA. For a more detailed discussion on this issue, see appendix IV.

Comparisons between defense and commercial industry are difficult as are comparisons between major defense contractors. However, such comparisons are necessary and should be made. To make the comparisons, some arbitrary decisions may be required. The result will be that the data from reporting companies may not be entirely comparable. However, we believe that individual differences will not be significant to the summarized data.

Comparing the profitability of defense contractors with similar companies in the commercial sector has long been accepted as one way of

¹Government Contracting: Assessment of the Study of Defense Contractor Profitability (GAO/NSIAD-87-50, Dec. 23, 1986).

assessing the relative profitability of defense business. During the 1960s, the Logistics Management Institute under contract to DOD compared defense business with commercially oriented companies and durable goods manufacturers. DOD continued such comparisons in Profit '76 and DEAR. The Logistics Management Institute made the comparisons because it believed profitability relationships with the commercial sector are essential to assess the level of profitability for defense contractors. One of DOD's profit policy goals is to attract companies to and retain them in the government marketplace. Comparisons are essential to determine if the two markets are profit competitive. We believe such comparisons should be made in all future profitability studies.

We agree that profitability trends must be looked at over many years. Our suggestion that profitability studies be made every 3 years does not mean that only 3 years worth of data should be used. As a data base is developed, each profitability study would include as many prior years data as considered necessary by the PRP Administrator to ensure the validity of the study.

A goal of profit policy is to provide incentives for investment. The purpose of investment among other things, is to increase efficiency in contractor operations. At best this can be measured indirectly through the use of the K L ratio. This is not a perfect efficiency measure but it is a reasonable indicator of the effect of investment on efficiency and can provide valuable insights concerning the effect of changes in profit policy, but it needs to be carefully interpreted by the Administrator.

Verifying and Protecting Individual Company Data

Government contractors and industry associations expressed concern over the layers of audit and review of the data and over the government's ability to prevent disclosure of individual company financial data.

Quotes From Comments

"While the penalties are intended to dissuade disclosure, the likelihood of disclosure is high. The damage to a contractor from disclosure could be excessive and a means of recovery from damage should be specifically provided for."

**Appendix V
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"We do not understand (sic) the Comptroller General's unwillingness to accept the work and veracity of independent certified public accountants. The work of independent CPAs is tightly regulated and controlled by the Securities and Exchange Commission. The GAO's refusal to rely on the work of CPA firms is without merit.

"... *engagement working papers are the property of the independent accountant* and subject to the ethical limitations relating to the confidential relationship with clients. Therefore the committee is opposed to proposed section 8 of the draft bill granting the Administrator access to '(working papers, documents, and records' of the independent accountant prepared in connection with the PRP engagement."

While PRP provides for access to company data by the Administrator and our office, it is not intended nor is it anticipated that the Administrator or our office would perform an in-depth review of company data each time it is submitted.

Under PRP, the reliability of the data would be established by the company's CPA firm. The Administrator needs access to company data to ensure that PRP rules and regulations are being interpreted and applied on a consistent basis by all covered companies. We need access to company data, CPA working papers, and Administrator records for limited testing to provide assurances to the Congress and the public that the data and program results are reliable.

Prior agency experience with sensitive data convinces us that data can be protected and our proposal includes limitation on access and penalties for disclosure. We believe that this, coupled with the requirements for protection of proprietary data, is adequate to protect the contractor's business data.

**Level of Audit by
Independent CPA**

The American Institute of CPAs recommended refinements and precision to our interpretations of their audit standards. We agree with their comments and have changed the report accordingly. (See page 28.)

More Study Is Needed

Some respondents recommended that further study be done to refine issues about profitability studies and a few recommended establishing industry-government teams to examine the entire process of studying contractor profitability. Others raised specific issues or questions that they believe should be resolved before implementing a PRP. (See page 31.)

**Appendix V
Summary of Comments: Contractors,
Industry Associations, Federal Agencies,
and Others**

We agree that there are issues and specific procedures and questions that are worthy of further consideration. Our legislative proposal builds on prior DOD studies which have had the benefit of significant input by agencies and contractors. The basic approach is not new. The PRP Administrator can, with the assistance of any parties deemed essential, study and resolve the "how to" details during the regulatory process.

Summary of Profitability Study Measures and Conclusions

DFAIR

ROA

Calculation: $\frac{\text{Economic Profit}}{\text{Assets}}$ (assets include government progress payments but do not include cash)

Conclusion:

Based on Cost Accounting Standards Board segment data analyzed for 76 participating companies, between 1970 and 1979, defense contractors and commercial contractors earned similar returns. Because of the early 1980s' recession, which according to DFAIR affected commercial business more than defense business, defense contractors, on defense business, earned higher returns between 1980 and 1983 than commercial manufacturers.

Return on Sales

Calculation: $\frac{\text{Economic Profit}}{\text{Sales}}$

Conclusion:

Same as for ROA.

Navy

ROA

Calculation: $\frac{\text{Operating Profit}}{\text{Identified Segment Assets}}$ (does not include cash)

Conclusion:

Using annual financial statements and industry segments defined by Financial Accounting Standards Board Statement of Financial Standards Statement Number 14 as the basis for study, for 22 contractors between 1977 and 1984, on average, ROA for government business (mostly defense) was higher than returns earned on commercial business.

¹Economic profit is a calculation devised by DFAIR to compare profitability on defense contracting with profitability of commercial manufacturers. The calculation of economic profit yields a lower ROA for both defense and commercial contractors than conventional ROA calculation. Adding progress payments to the asset base reduced contractor defense profitability more than it reduced commercial rates of return.

Return on Sales

Calculation: Operating Profit / Segment Sales

Conclusion:

Between 1977 and 1980 commercial sales showed higher return than government business; however, from 1981 to 1984, return on government business was higher than for commercial business segments. Very small and negative returns are more common in commercial business than government business.

**Air Force Systems
Command**

ROA

Calculation: Calculated for commercial manufacturers but not for defense contractors

Return on Sales

Calculation: Profit / Sales

Conclusion:

Return on defense segment sales for 15 companies studied was lower than total company return on sales for 1979 but was about the same for 1981. The Air Force concluded that in 1981 profitability of defense business was about the same as for commercial business.

Profit '76

ROA

Calculation: Profit / Assets (does not include cash or government progress payments)

Conclusion:

Based on government profit center data analyzed for 64 participating companies, between 1970 and 1974, average ROA for government profit centers was higher than for commercial manufacturers.

Appendix VI
Summary of Profitability Study Measures
and Conclusions

Return on Sales

Calculation: Profit / Sales

Conclusion:

Return on sales was higher for commercial manufacturers than for government profit centers.

GAO (1971 Defense Industry Profit Study)

Return on Total Capital Investment

Calculation: Profit / Assets

Conclusion

We studied 151 defense contractors, categorized as: large or small prime contractors, government-owned contractor operated plants, and subcontractors. Between 1966 and 1969, large and small prime contractors earned lower returns but subcontractors earned higher returns on defense work than on their commercial work.

Return on Equity Capital Investment

Calculation: Profit / Equity

Conclusion

For defense work compared with commercial work, large contractors' returns were about the same, small contractors' returns were lower, and subcontractors' returns were higher.

Return on Sales

Calculation: Profit / Sales

Conclusion:

Returns on defense work for large and small contractors were lower, but they were about the same level for subcontractors compared with commercial work. For government-owned contractor operated plants, returns for other defense related business (National Aeronautics and Space Administration and Atomic Energy Commission) were higher than for DOD business.

Logistics Management Institute

For its March 1969 Defense Industry Profit Review, Logistics Management Institute used a data sample consisting of: (1) data volunteered by 40 major defense contractors (companies with at least \$25 million annual defense sales and defense business accounting for at least 10 percent of the company's total business) and (2) a sample of 3,500 durable goods manufacturers filing reports with the Federal Trade Commission and the Securities and Exchange Commission. Separate profitability ratios were computed for the 10-year period (1958-1967) for the companies' defense business, their commercial business, and for the durable goods manufacturers' total business.

Return on Total Capital Investment (Before Tax)

Calculation: Profit / Total Capital Investment

Conclusion:

Defense business earned lower returns for 6 of the 10 years compared with commercial business and for 7 years compared with durable goods manufacturers. Defense returns were higher in the earlier years of the sample.

Return on Sales (Before Tax)

Calculation: Profit / Sales

Conclusion:

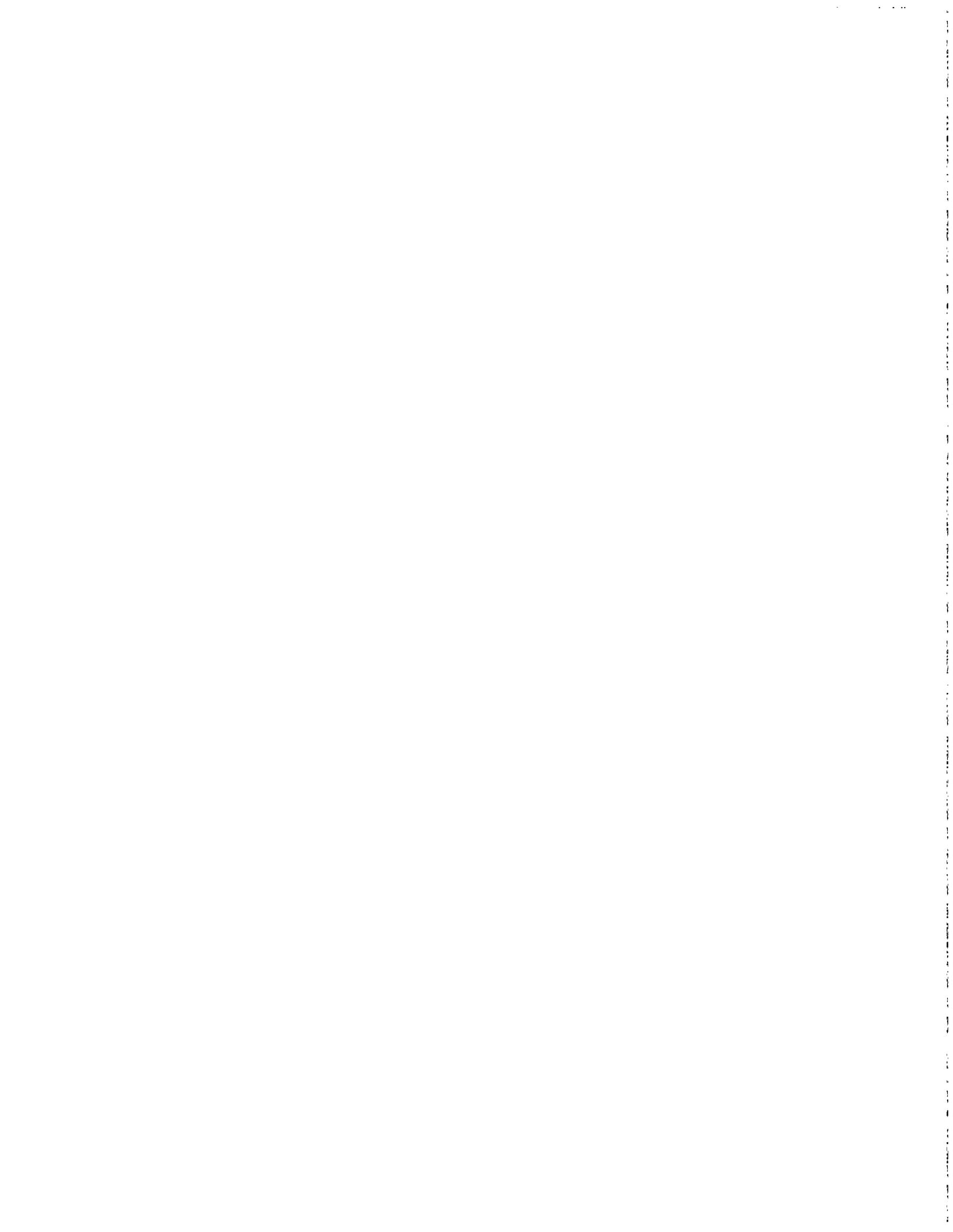
Defense business earned lower returns for 9 of the 10 years compared with commercial business and for all 10 years compared with durable goods manufacturers.

Return on Equity Capital Investment (Before Tax)

Calculation: Profit / Equity Capital Investment

Conclusion:

Defense business earned lower returns for 6 of the 10 years compared to both commercial business and durable goods manufacturers. Defense returns were higher in the earlier years of the sample.



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